

$$(-611) + 40,484 = 39,873$$

The sum of the current, capital and financial accounts should be equal to zero. If it is not the case, there are measurement errors, referred to as 'errors and omissions'. The balancing item is the result of the sum of the three accounts with the opposite sign. Summing the three accounts:  
 $(-38,780) + (-611) + 40,484 = 1,903$

So, the balancing item must be this sum with the opposite sign, or -1,903 (X7).

To calculate net current transfers subtract the payments made from receipts:  
 $6,657 - 7,652 = -995$  (X3)

The balance on the current account is the sum of all three sub-balances:

$$X4 = X1 + X2 + X3 \text{ or}$$

$$X4 = 7,622 + (-45,407) + (-995) = -38,780 \text{ (X4)}$$

To calculate X5, the balance on the financial account, we need to add net direct investment abroad + net portfolio investment + net other investments + reserve assets:

$$17,665 + 49,220 + (-14,505) + (-11,896) = 40,484 \text{ (X5)}$$

## Exercise 1

Determine whether the following statements are true or false. Explain your answers. Use a diagram to illustrate if possible.

- 1 A fall in foreign exchange reserves will result after a central bank's intervention to offset currency weakness.
- 2 Financing a current account deficit may force a country to run down its foreign exchange reserves, to increase interest rates or to borrow from abroad.
- 3 A persistent and large current account deficit decreases a country's ability to pursue domestic objectives such as higher growth and lower unemployment.
- 4 The money spent on hotels by foreigners visiting London at Christmas represent an import of tourism for the UK.
- 5 When a London-based mutual fund buys shares on the Shanghai stock exchange in 2010, then a debit is recorded in China's financial account (portfolio investment) in 2010.
- 6 The interest earned in 2011 by a Brazilian investor from the purchase of US government bonds in 2009 are recorded as a credit item for Brazil in its current account.
- HL** 7 A devaluation or sharp depreciation will correct a current account deficit if the sum of the PED for exports and the PED for imports exceeds unity.
- HL** 8 The trade balance of a surplus country will trace a J-curve following an appreciation of its currency.
- HL** 9 Expenditure-reducing policies attempt to slow down growth in order to curb demand for imports.

## Exercise 2

Rewrite the following statements and in the blanks by using the terms provided below. Some terms may be used more than once.

selling	supply	surplus
demand	competitive	unemployment
domestic	habits	cheaper
J-curve effect	imports	growth
unity	export driven	downward
widening	reducing	appreciate
manage	interest rates	undervalued
inflation	rising	price elasticities
deficit	informational	narrow
contracts	foreign exchange	worsens
Marshall-Lerner	inflows	short run

A (1) \_\_\_\_\_ current account (2) \_\_\_\_\_ puts pressure on the currency to depreciate or to devalue. Why? Because if the value of imports is (3) \_\_\_\_\_ faster than the value of exports, then (4) \_\_\_\_\_ of the currency is increasing faster than (5) \_\_\_\_\_ for the currency in the (6) \_\_\_\_\_ market. The resulting excess supply of the currency exerts (7) \_\_\_\_\_ pressure on its price. Conversely, rising export revenues resulting from (8) \_\_\_\_\_ growth will create a current account (9) \_\_\_\_\_ and pressure on the currency to (10) \_\_\_\_\_. Often, countries in such a situation (11) \_\_\_\_\_ their currency by (12) \_\_\_\_\_ it in

foreign exchange markets to keep it (13) \_\_\_\_\_ and so maintain their exports (14) \_\_\_\_\_ at the risk, though, of inducing (15) \_\_\_\_\_ at home.

Financing a deficit may force (16) \_\_\_\_\_ up in order to induce capital (17) \_\_\_\_\_. This, though, stifles (18) \_\_\_\_\_ and may increase (19) \_\_\_\_\_. To correct a persistent deficit the policymakers may opt for either expenditure-switching or expenditure- (20) \_\_\_\_\_ policies. Expenditure-switching policies aim at switching spending away from (21) \_\_\_\_\_ towards (22) \_\_\_\_\_ output by making imports pricier. Devaluation or sharp depreciation may do the trick with exports also becoming (23) \_\_\_\_\_ in foreign markets. The effect depends on (24) \_\_\_\_\_ of demand for exports and imports. It can be shown that for a deficit to (25) \_\_\_\_\_ it suffices that the sum of the price elasticities of demand for exports and imports exceeds (26) \_\_\_\_\_. This is known as the (27) \_\_\_\_\_ condition. Since elasticities in general tend to be low in the (28) \_\_\_\_\_, the condition is not immediately satisfied giving rise to the (29) \_\_\_\_\_. The current account deficit initially (30) \_\_\_\_\_ and only later, typically after 12 to 18 months, does it start to improve. Reasons for which price elasticities of demand for imports are low in the short run include (31) \_\_\_\_\_ constraints, as buyers do not immediately become aware of the new prices, (32) \_\_\_\_\_ (as buyers are used to specific products or sources of supply) and, more importantly, (33) \_\_\_\_\_ as importing and exporting companies have often signed long-term contracts with suppliers.

## Exercise 3

Match each term or concept with the appropriate definition or explanation.

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| 1 Visible or merchandise trade balance   | a The sum of net exports of goods and services plus net income from investments (including employees' compensation) plus net current transfers   |
| 2 Official reserves                      | b Defined as cross-border buying and selling of debt (bonds) or equity (stocks) and securities   |
| 3 Current transfers                      | c Net exports of goods (of physical merchandise)   |
| 4 Portfolio investment                   | d Errors and omissions   |
| 5 Balance of trade in goods and services | e Include foreign workers' remittances, pension payments to workers living abroad, payments of foreign aid, etc.   |
| 6 Current account balance                | f Net exports of goods and services  |
| 7 Balancing item                         | g Include foreign currencies, gold and special drawing rights that are available to the monetary authorities for meeting balance of payments financing needs as well as for intervention in foreign exchange markets to affect the exchange rate |